

~~Secret~~**Brazil: Bleak Economic Prospects** 25X1

Brazil continues to face foreign exchange difficulties despite the conclusion of new loan agreements. The government is now making the adjustments required to retain crucial bank support but, with the austerity program already drawing fire, it probably will waver and fail to meet all IMF targets. At best, Brazil this year will experience a contraction of 3 to 5 percent in economic activity accompanied by a 95-percent rate of inflation, and growing political unrest. 25X1

The risk remains that Brasilia may yet declare a payments moratorium; indeed, the financial press is openly speculating that a payments suspension is imminent. Such an event would lead to a cessation of all new lending, causing economic activity to plummet at a 10-percent annual rate while driving inflation into triple digits. Under such conditions, Brazil's economic crisis would severely test the government's ability to cope with political stress, spill over to other South American borrowers, and adversely affect US bank and business interests. 25X1
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The Government Responds

Since December, Planning Minister Delfim Netto has tried to engineer a major rescue operation. To regain banker support, he promised a variety of policy adjustments. A stabilization plan, endorsed by the IMF, calls for tough measures to slash the 1983 current account deficit 50 percent to \$7 billion and to reduce inflation to an annual rate of 70 percent by December. 25X1

According to Embassy and press reporting, Brasilia has moved to slow the economy and strengthen the external accounts. To reduce the public deficit, Brasilia ordered new cuts in Treasury spending, a 20-percent reduction in state corporation investment, tax increases, and hikes in public-sector

tariffs. The National Monetary Council tried to slow rapid monetary expansion by increasing agricultural interest rates, tightening eligibility standards for some subsidized credits, and ordering price hikes aimed at phasing out wheat and petroleum product subsidies. The government's economic team also announced a modification of wage policy, a large devaluation to stimulate exports and restrain imports, and cuts in overseas tourist allowances. 25X1

The economic retrenchments have provoked sharp criticism of government policies from opposition politicians, the media, and union leaders. The abrupt shifts in policy have drawn fire, especially in the new Congress. Embassy and press reporting also indicate that Brazilian businessmen have become increasingly critical of the government's economic strategy. Moreover, restrictions in the salary law and rising unemployment are causing frequent wildcat strikes. 25X1
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Without violating its IMF agreement, Brasilia has taken steps to assuage its domestic critics and regain business confidence. In February the government reinstituted price controls on 273 products in an effort to dampen inflation. On 4 March the government announced three new programs to help small businesses obtain additional financing and promote exports. Later in the month, the National Monetary Council announced a series of measures aimed at lowering domestic interest rates and ending speculation in the financial markets. Additionally, Brasilia has attempted to offset some of the adverse impact of the February devaluation by instructing banks to make available new credits at preferential rates to firms with dollar-denominated debts and lowering import taxes on purchases of mineral, metal, and chemical products. 25X1
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Secret**Brazil's Financial Package**

Following the extension of the \$1.2 billion loan from the United States in December, Brasilia still found it had serious financial problems. This made it imperative to obtain IMF financial assistance and commercial bank lending support. []

The IMF

The IMF will provide Brazil with \$5.9 billion in financial assistance through 1985 in return for its pledge to make economic adjustments. This includes \$4.8 billion under a three-year Extended Fund Facility, and \$1.1 billion from the Compensatory Financing Facility. Brazil withdrew \$500 million from the CFF in December and plans to take \$2.5 billion from both facilities this year. []

The Private Banks

Support from the IMF was contingent upon assistance from private banks. On 20 December 1982 Brasilia petitioned its leading creditors for a four-part financial package including:

- A \$4.4 billion medium-term loan, which would increase bank exposure in Brazil by 7 percent.

- Rollover of principal payments owed to commercial banks maturing this year. The rollover would be made directly to Brazil's Central Bank for eight years and contains a two-and-one-half-year grace period.

- Continued access to \$8.8 billion in short-term trade related credits—mostly for raw material imports and export prefinancing.

- Restoration of \$5 billion in interbank credit lines with Brazilian bank branches abroad. []

Brazil completed the first two parts of the financing program in February. Bankers have committed an estimated \$10 billion in short-term trade financing facilities but are still reluctant to disburse these lines. West European, Japanese, and smaller US banks have resisted fully restoring interbank deposits []

Brasilia has a long and treacherous path yet to travel. The last few months have seen inflation spurt to an annual rate of 105 percent in February, and the \$330 million trade surplus through February was nearly 70 percent short of the level needed to meet the IMF target. According to Embassy reporting, the economic team has begun to lose credibility, and no near-term successes are in sight. The large devaluation in late February will push inflation higher in March while doing little to strengthen the trade accounts. []

The Eye of the Storm

Over the next several months we anticipate a resurgence of external financial difficulties. Even with the disbursements of most of the new loans in

mid-March, Brasilia is already encountering renewed foreign exchange difficulties. []

Until bankers resume short-term lending and exports strengthen, Brazil probably will have difficulty covering its daily cash position. Unless bankers reactivate standby credits, either Brazil's arrearages will continue to increase in the face of roughly \$2 billion in monthly import and interest payments or sorely needed goods will stop flowing in and the recession will worsen sharply. []

Failure to stop capital flight will add to persistent cash-flow difficulties. []

Secret

8 April 1983

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[] growing doubts about Brazil's economic prospects caused businessmen to channel funds into overseas money market accounts this year. Renewed speculation about another large devaluation will provide new incentives to get funds out of the country. []

Despite the large devaluations, we anticipate lackluster export performance until at least late summer. Although Brazil may reach its \$22 billion export target for 1983, exports will be stalled for a while by weak recovery in consumer and industrial demand in the developed countries, weak commodity prices, and tougher import restrictions in Brazil's major Third World markets. Beyond this, a continuation of exports outside of official channels could also hinder the government's ability to achieve its goals. []

We judge that Brasilia's economic team will also have problems in complying with the IMF's domestic performance targets.¹ The failure to increase interest rates for export credits, the lack of a precise timetable for phasing out product subsidies, and the application of only a moderate increase in agricultural interest rates is already translating into stronger-than-anticipated demand for funds. According to Embassy reporting, monetary expansion surged to a 97-percent annual rate in February compared with 85 percent for 1982. Beyond this, the large devaluation and the failure to apply tough wage restraints will continue to fuel inflation. Based on Embassy reports, we doubt that Brasilia will meet its public-sector financing targets. The

¹ Some problems have already arisen. On 5 March, Brasilia amended the original IMF agreement. Because of the large devaluation, the government revised its inflation target to 85 to 90 percent in December. It also respecified quarterly balance-of-payments performance requirements but did not modify the annual external targets. []

initial expenditure cuts and revenue measures probably will prove inadequate to offset automatic spending increases triggered by rising inflation. []

These problems augur renewed tensions in dealing with the international banking community. With arrearages again building, Central Bank President Langoni has renewed appeals to creditors—without success thus far—to provide new standby credits to meet immediate obligations. We []

[] expect Brasilia will seek \$2-4 billion in new loans before the end of September. Any such request for funds probably will be greeted by demands for even tougher austerity measures. [] lenders will require even deeper import cuts, wage restraints, public spending cutbacks, and controls on the money supply before making any new loans. []

Even as difficult new adjustments are required, we believe Brasilia will encounter intensifying domestic criticism of its stabilization program. Based on past experience, state corporations, agricultural producers, and businessmen probably will bid for concessions to blunt the impact of austerity. As consumer prices and unemployment rise, opposition will broaden to include the middle class and labor. The increased assertiveness of the Congress and state governors that has grown out of recent political liberalization will complicate efforts to carry out the austerity program. At this juncture, we believe the government is likely to hold the line on the measures already enacted but waver on implementing unpopular new measures that could spark political problems. []

The Economy in 1983

We believe the only plausible scenarios for Brazilian economic performance entail declines in real output this year. The severity of the decline will depend on the willingness of Brazil's foreign creditors to provide additional financial support. We

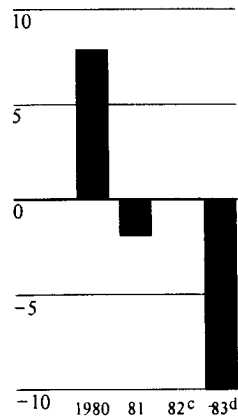
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8 April 1983

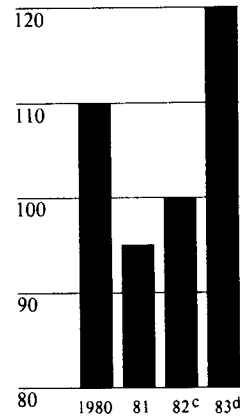
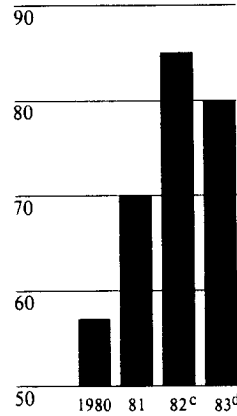
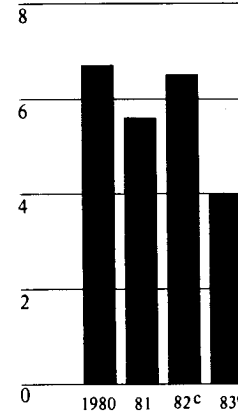
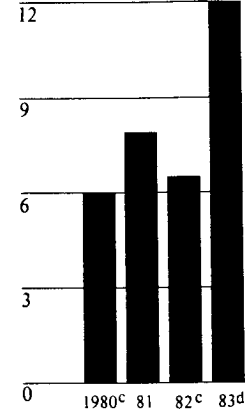
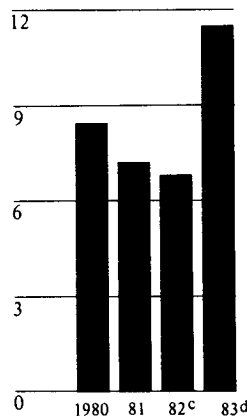
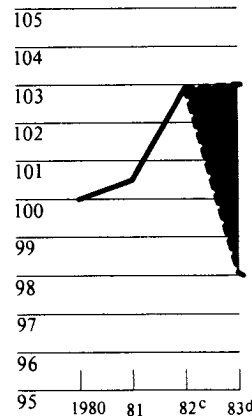
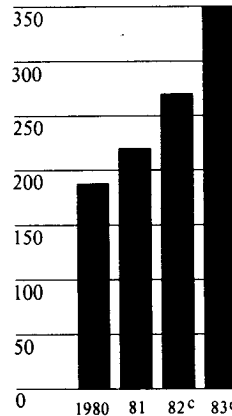
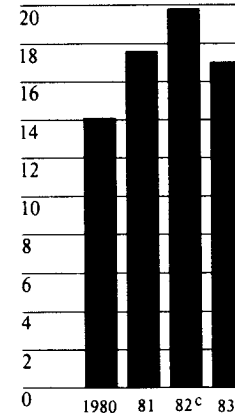
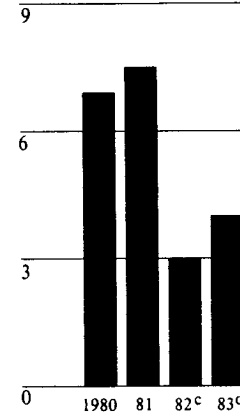
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Brazil: Economic Indicators

Note scale change

Real GNP Growth
Percent

Shaded portion of bars and dashed lines indicate range.

Cost of Living
Percent Change^a**Monetary Expansion^b**
Percent**Government Deficit**
Percent of GDP**Urban Unemployment**
Percent**Business Failures in Sao Paulo**
Thousands**Agricultural Production^e**
Index: 1980=100**Oil Production**
Thousand b/d**Debt Service^f**
Billion US \$**International Reserves^g**
Billion US \$^a December to December.^b Change in the money base.^c Estimated.^d Range estimates, best case assumes Brazil is able to finance an \$8 billion current account deficit; worse case assumes Brazil declares a payments moratorium.^e Production of beans, corn, manioc, rice, soybeans, and wheat.^f Interest payments and long-term principal repayments.^g Mainly illiquid in 1982 and 1983.

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8 April 1983

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Brazil: Balance of Payments

Billion US \$

	1980	1981	1982 ^a	1983 ^a	
				Case A ^b	Case B ^c
Current account balance	-12.4	-11.0	-14.5	-8.0	5.5
Trade balance (f.o.b.)	-2.8	1.2	0.8	4.5	7.0
Exports	20.1	23.3	20.2	21.5	20.0
Imports	22.9	22.1	19.4	17.0	13.0
Service balance, net	-9.6	-12.2	-15.3	-12.5	-12.5
Interest payments	7.4	10.3	12.0	9.7	9.7
Debt repayments	12.7	16.3	20.8	20.2	20.2
Longer term maturities	6.7	7.3	7.8	7.2	7.2
Short-term maturities	6.0	9.0	13.0	13.0	13.0
Gross foreign exchange requirements	25.1	27.3	35.3	28.2	25.7
Financed by:					
Direct investment, net	1.1	1.6	1.1	1.0	1.0
Official and supplier credits	4.2	3.4	5.2	4.0	3.5
Loans	18.4	24.2	27.0	24.7	22.7
Bridge operations			4.0	-3.0 ^d	-3.0 ^d
Short-term rollovers	6.0	9.0	10.0	13.0	13.0
Short-term borrowings	3.5	1.5	0.5	0.5	1.5
Long-term credits	8.9	13.7	12.5	14.2 ^e	11.2 ^e
Other	1.4	-1.9	2.0	-1.5	-1.5

^a Estimate.^d Central Bank of Brazil estimate.^b Assumes Brazil obtains bank support.^e Includes \$2.5 billion from IMF.^c Assumes Brazil declares a moratorium in the summer of 1983.

have analyzed the domestic and international results for the Brazilian economy—drawing upon our own work and that of econometric services and independent analysts—under the assumption that international bankers accommodate a request for some additional financial support. In the worst case, we have tried to assess the consequences for Brazil if its foreign funding dries up later this year.

The Likely Course. Although world economic recovery and lower oil prices probably will lead to a \$4-5 billion trade surplus for Brazil in 1983, this will still fall short of the \$6 billion IMF target. Even with the fall in world interest rates, the

government probably will reduce its current account deficit only to some \$8 billion this year. As the trade shortfall becomes apparent, the Brazilians probably will have to ask creditors for another loan.

we believe bankers will accommodate Brazil if the government is perceived to be making a good-faith adjustment. The bankers appear willing to extend some additional financial support as long as Brasilia sustains its stabilization program, its efforts to increase exports, and its willingness to service the debt. Even so, we foresee temporary funding gaps.

Secret

8 April 1983

Secret

Belt tightening and foreign financing constraints will cause national output to fall by 3 to 5 percent. The economic contraction—borne by industry and domestic commerce—will be accompanied by growing unemployment and business failures. Despite wage restraints and price controls, the December over December inflation rate will approach triple digits because of the large devaluation, increases in public utility rates, and import restrictions. []

Another year of worsening economic performance will heighten social unrest. Economic deprivation following retrenchment and persistent triple-digit inflation probably will increase violent crime, wild-cat strikes, and cost-of-living demonstrations. Because of its firm monopoly on the instruments of force, we believe the Figueiredo government will be able to avoid serious problems. Moreover, the government probably will appeal to Brazilian willingness to make sacrifices for *grandeza*, major power status. []

A Worst Case Scenario. If the government misses its stabilization targets by a wide margin, however, bankers probably will refuse new credit requests. With its reserves depleted, Brasilia would have little choice but to declare a temporary moratorium on debt payments. Such a declaration would cause a cessation of all foreign lending until new austerity and rescheduling arrangements are worked out. With its borrowings cut, we believe Brasilia would be forced to reduce the current account deficit to \$5.5 billion, mainly by slashing imports. []

The economy probably would go into a severe tailspin. The reduced availability of critical raw material imports—metals, oil, chemicals—would cause severe disruptions in industrial production. We estimate that real growth would fall at a 10-percent annual rate as the industrial downturn reduced new investments and caused declines in construction and commercial activities. A severe cash-flow squeeze probably would result in a wave of business failures, sending unemployment into double digits. In these circumstances, commodity shortages would boost inflation above 100 percent.

Such an economic crisis would severely test the government's ability to cope with political stress. At this juncture, however, we cannot judge the likely consequences. []

Signs To Watch

New external shocks could quickly gut Brasilia's stabilization program. With the debt service ratio hovering at the 80-percent level, any export shortfalls induced by climatic disaster, low commodity prices, or continued recession in industrial nations would pose unmanageable financial strains. Brazil also remains vulnerable to higher world interest rates; a 1-percentage-point increase in LIBOR would add an estimated \$500-600 million annually to debt servicing obligations. Beyond this, Brasilia may yet be forced to declare a payments moratorium if its major creditors split over the country's financial strategy and thereby prevent the syndication of a large new credit. []

Failure to regain public confidence could also have serious economic consequences. Speculation in the financial markets would intensify, preventing any increase in domestic capital formation. Businessmen probably would continue to postpone most new investment programs at home and persist in capital flight. []

Implications for the United States

We believe Brazil will increasingly look to the United States for support in resolving its financial problems. Until private bankers reconstitute the safety net arrangement, Brasilia probably will call on Washington from time to time for emergency financial support. Based on Embassy reporting, we also expect the Brazilian Government to press Washington to lead the effort to reschedule official credits maturing in 1983. As the need for new money becomes apparent, Brasilia may expect the United States to back credits to finance imports and assistance in discounting trade receivables with US banks. []

Secret

8 April 1983

Secret

Any disruption in debt servicing could spur Brasilia to seek debt relief. A formal debt rescheduling would be forced to consider stretching principal and interest payments to lessen Brazil's foreign exchange stringencies. Interest payments are now the single-largest outflow in the current account, claiming 45 percent of export earnings. If, in the worst case, bankers were unwilling to cooperate, a prolonged interest moratorium would further reduce US bank profits and could cause some severe problems. Moreover, Brazil's troubles would adversely affect other South American borrowers, further intensifying the adverse impact on the US economy as they make even tougher import cuts and suspend repayments.

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A payments moratorium remains a continuing possibility. Much of the immediate impact of a moratorium would fall on the nine largest US commercial banks' profit positions. Brasilia would also face the need to make larger-than-anticipated import cuts, thereby reducing even further US exports to that market.

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